

VZCZCXRO6621
RR RUEHFK RUEHKSO RUEHNAG RUEHNH
DE RUEHKO #5288/01 2570342
ZNR UUUUU ZZH
R 140342Z SEP 06 ZDS
FM AMEMBASSY TOKYO
TO RUEHC/SECSTATE WASHDC 6374
INFO RUEHBJ/AMEMBASSY BEIJING 4169
RUEHGP/AMEMBASSY SINGAPORE 6753
RUEHFK/AMCONSUL FUKUOKA 8058
RUEHNAG/AMCONSUL NAGOYA 7829
RUEHNH/AMCONSUL NAHA 0614
RUEHOK/AMCONSUL OSAKA KOBE 1404
RUEHKSO/AMCONSUL SAPPORO 9152
RUCPDO/DEPT OF COMMERCE WASHINGTON DC
RUEHRC/DEPT OF AGRICULTURE WASHINGTON DC
RUEATRS/TREASURY DEPT WASHDC

UNCLAS SECTION 01 OF 03 TOKYO 005288

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EB FOR A/S SULLIVAN
USTR FOR AUSTR CUTLER AND MBEEMAN
AGRICULTURE FOR USDA/OSEC, FAS/ITP, FAS/FAA/IO/NA
USDOC FOR 4410/ITA/MAC/OJ/NMELCHER
TREASURY FOR IA/DOHNER, HAARSAGER, AND YANG

E.O. 12958: N/A
TAGS: [ECON](#) [PREL](#) [EFIN](#) [ETRD](#) [ECIN](#) [JA](#) [APECO](#)
SUBJECT: SCENESETTER FOR EB A/S SULLIVAN: INCOMING
CABINET'S ECONOMIC POLICY OUTLOOK

REF: A. STATE 132255

[1](#)B. TOKYO 4025

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Summary

[1](#)1. (SBU) With Chief Cabinet Secretary Shinzo Abe the presumptive next prime minister, beef receding from the economic agenda, and a summit with President Bush anticipated in the coming months, your visit to Tokyo comes at an important point in discussions of how to broaden and deepen the bilateral economic relationship. The USG and GOJ raised potential areas of cooperation, such as secure trade, IPR, and investment initiatives, at the economic sub-cabinet meetings in June. Meanwhile, both U.S. and Japanese business representatives have urged our governments to take steps toward an FTA or economic integration agreement. We suggest that now is the time to assess how bold the next round of USG proposals can be, given Japan's current economic policy outlook. We believe there are three key areas on which to evaluate the incoming leadership's economic policy: the GOJ's commitment to growth, the orientation of its fiscal policy, and its ability to bring strategic coherence to its trade and regional economic relations. Your meetings will take place as ministries are making their own assessments of how the new leadership will proceed on IPR as well as the broader agenda. End summary.

The GOJ's Commitment to Growth: Reform and Investment

[1](#)2. (SBU) Japan has emerged from the economic slump of the 1990s, largely putting its non-performing loan crisis and fourteen-year property market slump behind it and gradually emerging from its decade-long struggle with deflation. A steady stream of reforms has fostered large-scale restructuring and recovery, and the privatization of Japan Post, the centerpiece of PM Koizumi's reform agenda, commences in 2007. The privatization of the post office's banking and insurance arms, which collectively hold assets

exceeding \$3 trillion, could make enormous amounts of currently underutilized capital available to domestic and world financial markets.

13. (SBU) PM Koizumi strongly pushed structural reform as central to the restoration of growth, but many in Japan remain unconvinced that the results are worth the economic and social costs. Some have even simplistically blamed reform and deregulation for recent high-profile scandals over faked earthquake resistance data and insider trading, eliciting fears in some corners that Koizumi-style structural reform has undermined the Japanese economy. We believe, however, that further economic reform will be a main determinant of whether the economy can maintain robust growth. In the short term, the new Cabinet economic lineup and decisions on how to staff and strengthen the Committee for the Promotion of Regulatory Reform (CPRR) will indicate the seriousness with which the new leadership intends to address Japan's economic challenges.

14. (SBU) We will also be watching efforts to boost economic vitality through foreign investment. PM Koizumi's five-year effort to double the stock of inward foreign direct investment successfully enabled foreign companies to revitalize struggling concerns, increase competition, and foster improvements in goods and services for consumers. Nonetheless, important investment incentives, such as allowing triangular mergers, are yet to be fully implemented.

The new Cabinet's public openness to and support for FDI will be needed to contain a potential populist backlash against "foreign style" mergers and acquisitions and other measures that help to advance productivity in the Japanese corporate sector, which is necessary to maintain strong growth.

Fiscal Policy: Resources for New Initiatives

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15. (SBU) Japanese government debt stands at approximately 175% of GDP (comparatively, the U.S. debt is around 63%) and the GOJ continues to run a deficit of almost 6% of GDP. While the current fiscal situation is generally seen as unsustainable, the last consumption tax increase, from 3% to 5% in 1997, is blamed for prolonging the slump of the "lost decade." Even Finance Minister Sadakazu Tanigaki, the prime ministerial candidate seen as most inclined to boost tax rates, has not called for increases before 2010 (legislative realities would prevent any candidate from effecting an increase before 2009). That leaves the question of what expenses the government will cut. PM Koizumi consistently targeted pork-barrel public investment and downsized government payrolls. Future belt-tightening will likely involve more difficult policy trade-offs, and the current budget framework for FY07 calls for cuts in areas of strategic importance to the United States, such as official development assistance (ODA) and defense spending. Cuts to ODA, for example, could limit plans to broaden cooperation under the Strategic Development Alliance, and the trimming of personnel in ministries responsible for energy programs, IPR protection, or transportation security could test the GOJ's ability to undertake related initiatives. All parts of the USG will need to be cognizant of the tight fiscal situation facing Japan when considering increased Japanese financial contributions to bilateral or multilateral activities.

16. (SBU) Significant new domestic social programs could also compete for resources. A recent OECD report that highlighted rising income inequality in Japan has added fuel to a national conversation about whether there is a widening divide between stable, career workers and part-timers, and between large cities and outlying regions. Abe's platform suggests he might play to this issue through new social safety net and "family-friendly" programs targeting medical, education, and pension benefits. With the population aging rapidly and the pension burden already rising, we see the

incoming Cabinet's response to social inequality issues as a potential bellwether for how it will balance the competing needs to reform, control the budget, and address domestic political demands.

Strategic Coherence: Regional Architecture and Trade

¶17. (SBU) How the incoming leadership sees its economic relationships with China and Asia will also be a key question. Will the incoming administration have a strategic vision for integrating various proposals, including ASEAN 6 and the East Asian Summit, into existing regional structures?

Or will the various initiatives have little or no consideration of their impact on existing regional institutions like APEC or on the U.S. role in region? We will look for substantive support for APEC, as well as consultation on new regional proposals, in assessing the viability of regional architecture as a focus of our strategic economic dialogue.

¶18. (SBU) Similarly, sustained efforts to keep agricultural trade issues off the political agenda and in the technical realm following internationally accepted standards will be needed to maintain our attention on further improving our economic relationship. Another suspension of beef imports, or a series of other agricultural import restrictions based on consumer safety issues, could turn a managed irritant into a serious impediment to progress.

Intellectual Property Rights Agenda

¶19. (SBU) On IPR, the USG has shifted its focus over the past year from our (relatively minor) bilateral complaints about the adequacy of Japan's IP protection to an emphasis on greater cooperation, using IPR as a means for greater U.S.-Japan economic integration and for improving the international environment for IP protection. While both sides agree on the potential for cooperation on IPR, the

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specifics have proved elusive. The most substantive progress has been the work of the two Patent Offices in launching the pilot "Patent Prosecution Highway" in July 2006, with the long-term goal of mutual recognition of patents. The most notable failure has been the GOJ's unwillingness to join USTR in an IPR case against China at the WTO. Japanese companies, concerned about Chinese retaliation, are strongly against it, and the GOJ has told us it is committed to its current IPR dialogue with China -- one of the few bright spots in Japan-China diplomatic relations. Within the GOJ, the Ministry of Economy, Trade, and Industry (METI), specifically Minister Nikai, has been the primary opponent to Japan joining the WTO case. That opposition is unlikely to change in the next few months, even with the appointment of a new minister.

¶10. (SBU) You will be meeting IP Strategy Headquarters (IPSH) Secretary-General Hisamitsu Arai, who has used his position in the Cabinet Secretariat to substantially improve Japan's protection of intellectual property over the last five years. He is a strong backer of a U.S.-Japan bilateral IPR agreement and gave us a draft of a statement on IPR for the next U.S.-Japan summit (ref B). The concept for a new anti-counterfeiting agreement originated in his office two years ago and he strongly supports USTR's proposal for an Anti-Counterfeiting Trade Agreement (ACTA). However, he has also warned that it would be foolish if developed countries wasted time and effort arguing about what a Gold Standard is while counterfeiters went about their business. Arai and the IPSH staff will continue to be the key players on IPR policy under the new prime minister, and this will be an early opportunity to explore where and how far we can move forward on a joint IPR agenda in the coming years. (Note: The Ministry of Foreign Affairs has the lead on negotiating the ACTA text.)

Conclusion

11. (SBU) Your meetings in Tokyo provide an excellent opportunity to energize key private sector and government decision-makers on the need for continued reform, strategic thinking on trade and regional economic issues, and progress on IPR initiatives. Speculation varies about the makeup of the new Cabinet economic team, but we sense a certain complacency among our economic interlocutors, who seem generally satisfied with the current path of the economy. Moreover, Abe's policy interests appear to lean more toward a number of high-profile security and political efforts, such as elevating the Japan Defense Agency to ministry status and re-examining Japan's constitutional military limits. It is natural for the urgency felt during Japan's slump to dissipate with the economy's recovery, but the logic of continuing to broaden and deepen our relationship remains as strong as ever. In engaging your interlocutors on key economic themes, your visit will be timely in shaping discussion of the next round of bilateral economic initiatives, including consideration of eventually launching negotiations toward an FTA or economic integration agreement.

SCHIEFFER